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NOTES

THE CAPITALIZATION PROCESS

In the discussion of interest in Professor H. J. Davenport's book on *Value and Distribution* is the following formulation: "The value of any productive instrument is the present worth of all the future incomes attributed to it, as computed under the time-discount rate established in the loan fund market."¹

This is the conventional and typical theory of capitalization. The paragraph is in italics and is evidently meant to be a concise and accurate statement of doctrine. The errors it contains could only result from a failure to make a clear analysis of the process by which a productive instrument has a value put upon it. The purpose of this criticism is to make clear certain phases of that process and to show that a prevailing rate of interest does not necessarily have anything to do with the fixing of the values of production goods.

To say that the value of an instrument is found by the discounting of its putative future incomes at one market rate is to infer that those incomes are of a specific market quantum. It presupposes a homogeneity of entrepreneurs, when as a matter of fact not only are entrepreneurs different in themselves but each occupies a situation peculiar to himself in relation to the instrument. The productive importance of an instrument, whether it be a piece of land, a machine or what not, is different for each different entrepreneur. The instrument fits into the business of each in a different way. A farmer with large hay barns would not be likely to pay much for a hay-stacker but would pay a good price for a hay-loader. With his neighbor, who is just as well off in other ways but who stacks his hay in the open, the reverse is true. The man who can get most out of an instrument is the one who, other things being equal, can pay the most for it. He pays what he has to, and whatever he gets out of it more than could his closest competitor at the same expense is a producer's surplus.

¹ P. 242.

The market price of an instrument need not, and usually does not, represent all the present worth to the purchaser of the rents he expects to get from it. Then what present worth does it represent? Is it a general average of present worths? The various possible sums of rents from the same instrument to different entrepreneurs should, in strict logic, be discounted into various present worths. How are those worths all accounted for in the fixing of the market price? This brings us to the question whether the same discount rate is used by all entrepreneurs.

What is it that determines whether we buy a typewriter or a bicycle? How does the farmer decide whether to buy a rake or a corn planter, another horse to use in farming, or a better wagon on which to haul his produce to market? In each case the cost and the income services of one good are weighed against the cost and the income services of the other. But in small transactions, such as these, a decision is reached by lump comparisons. The discounting process is less exact than in more extensive buying, partly for the reason that the smaller the transaction, the less likely is the buyer or seller to haggle over the price, and partly because the purchaser of a single complementary instrument of production does have for his individual consideration a problem of distribution. The purchase made is the one that promises the largest returns in proportion to cost, but the purchaser probably could not express those returns as a fraction of the purchase price.

Let us consider now a larger transaction in which an exact discount rate is used: for example, the buying of a business. The careful investor does not bid for a business on the basis of the returns the present owner is getting. Those returns do not occupy the greater part of his attention. He rather finds out what advantages the present owner has that he himself will not have, and especially what forces he can bring to bear that the present owner does not wield. When satisfied as to what he can make out of the business, he takes steps to find out the lowest price at which he can get control of it. This done, he compares the purchase price and the yearly income to find what will be his rate of return from the investment. When several opportunities are before him, he chooses the one that promises the highest rate of return, the rate of return from the next best possible investment being the standard by which he judges the best. It is only when he debates the ques-

tion whether to lend or to invest, or considers as to the advisability of borrowing additional capital for investment, that the market rate of interest is necessarily a part of his calculations.

When we say that entrepreneurs differ as well as their situations, it might be objected that at last a part of the income that one entrepreneur gets, more than could another, from the use of an instrument, is due to differences in the men and should be attributed to him as profit rather than be classed as rent from the instrument. This is undoubtedly the case; but it remains true that the rents also are different and that each man makes up his own mind as to what he can afford to pay for the instrument. Then for the purposes of our present problem it is not necessary to enter into a discussion of the apportionment of these differences of incomes into profits and rents.

What, then, in the light of this discussion, can be offered as an improvement over the formulation criticized? Theoretically, it may be said that the market value of a given productive instrument is equal to what the marginal investor in that line of goods estimates to be the present worth to him of all the incomes that would accrue to him with the use of that instrument. But it is nevertheless true that the market value of a productive instrument is fixed by the equating of demand and supply forces. Each of the competing entrepreneurs whose bids make up the demand makes his own estimate of the incomes that will come to him from the use of the instrument in question, and he also computes the present worth of those incomes by the use of a time-discount rate peculiar to himself. Value does not accrue to a productive instrument by virtue of the value of its products except in the same inaccurate sense in which the value of a consumption good comes from the utility contained in it. Each sort of goods must go through a market to have a market value put upon it. Even though a good is unique and has never been sold, its value comes to be estimated according to the offers the owner must refuse in order to keep it. Value, wherever found, is the resultant of forces that come to bear only where there is the personal activity of various individuals bidding for the items of a supply.

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